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Agenda Item 4e

April 11, 2011

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. **SUBJECT:** Adoption of Policy on Real Assets and its components: Real Estate, Infrastructure, and Forestland
- II. **PROGRAM:** Real Assets
- III. **RECOMMENDATION:** Recommend to the Investment Committee Adoption of the Statement of Investment Policy for Real Assets in May 2011
- IV. **ANALYSIS:**

Background

In December 2010, the Investment Committee ("Committee") approved an alternative asset classification as part of the overall Strategic Asset Allocation process. The approved classification called for the creation of a new Real Assets class comprised of the Real Estate program, and the Infrastructure and Forestland programs from the Inflation-Linked Asset Class.

In February 2011, the Committee approved a new Strategic Plan for Real Estate.

In February and March 2011, Staff developed a single overarching Real Assets policy to govern the consolidated program. Attachments to the policy will be utilized for the Real Estate, Infrastructure, and Forestland programs. Additionally, Staff revised the Real Estate policy to reflect the approved new Strategic Plan. Sub-attachments in the Real Estate policy will be utilized for investment programs with specific Board directives. As part of the consolidation process, Staff is requesting repeal of existing policies on the Inflation-Linked Asset Class and Real Estate in Agenda Item 4f.

Staff believes a single overarching policy will provide more effective policy directives and controls on investment activities for the new Real Assets class. Staff worked closely with the Investment Strategy Group and other stakeholders to solicit feedback and comments on the proposed new policy and revised Real Estate policy. The General Pension Consultant, Wilshire; Real Estate Consultant, Pension Consulting Alliance; and Infrastructure Consultant, Meketa; have reviewed the proposed policy and opinion letters are included in attachments as listed below.

List of Attachments

- Attachment 1 - Proposed New Real Assets Policy
- Attachment 2 - Proposed New Real Assets Policy Glossary
- Attachment 3 - Wilshire Associates Opinion Letter
- Attachment 4 - Pension Consulting Alliance Opinion Letter
- Attachment 5 - Meketa Opinion Letter

Summary of Proposed Additions or Changes

1. New parent “Real Assets” policy created with component program attachments for Real Estate, Infrastructure, and Forestland.

- A. Component Programs. Revised Real Estate policy to reflect approved Strategic Plan. Incorporated current stand-alone Agricultural Land Policy into the Real Estate policy as sub-attachment. Infrastructure and Forestland component programs transferred with minimal administrative changes from the Inflation-Linked Asset Class policy.
- B. Role of Consultants. Updated to reflect revised role per Policy Subcommittee (“PSC”) February 2011 Information Agenda Item 3, and concurrent PSC April 2011 Action Agenda Item 5.
- C. Strategic Objective and Role. Per approved Strategic Asset Allocation, objective is to provide long horizon income return that is less sensitive to inflation risk. Role is to meet a real rate-of-return of 4 percent, after fees.
- D. Program Allocation. Real Asset target and range limit specified according to approved Strategic Asset Allocation. Includes targets and range limits for component program allocations.
- E. Reporting to the IC Quarterly. Staff to report on (1) actual performance of component programs vs. their respective benchmarks, and (2) actual allocations vs. targets and ranges. General Pension Consultant requirements revised to include reporting of consolidated program actual performance vs. strategic role.

2. Revised Real Estate policy to reflect approved new Strategic Plan.

- A. Strategic Objective. Updated to reflect new Strategic Plan. Added “Role” of Real Estate per approved Strategic Asset Allocation.
- B. Benchmark. Will be changed in Benchmark Policy to NCREIF Fund Index – Open End Diversified Core Equity (ODCE) from 200 bps over NPI (90%) and FTSE EPRA NAREIT Global RE (10%).

- C. Bifurcate Total Portfolio. Into (1) Strategic (New) Portfolio, and (2) Legacy Portfolio.
 - i. Sub-divide Strategic Portfolio into Base, Domestic-Tactical, and International Tactical Portfolios w/ sub-allocation range limits and objectives and descriptions.
 - ii. Stipulate that Legacy Portfolio be managed to optimization.
- D. Diversification and Limits. To implement the Strategic Plan and optimize the Legacy Portfolio during anticipated 5-7 year transition period to full compliance with the new policy, Staff may approve transactions in cases where key policy parameters (such as geography, portfolio leverage, risk classification, etc.) exceed limits or the transaction would cause limits to be exceeded on a prospective basis. Further detail regarding this change is included later in this Agenda Item cover memo.
 - i. Staff must update the Committee quarterly on progress toward implementation of the Strategic Plan and compliance with policy.
- E. Key Policy Parameters
 - i. Risk Classification (Core/Value Add/Opportunistic). Range limits revised per new Strategic Plan. REITs limit reduced from 25 percent to 5 percent.
 - ii. Geographic Guidelines. Range limits updated to reflect weighting of new U.S. emphasis in Strategic Portfolio.
 - iii. Property Type Limits. Office, Industrial, Retail, and Multifamily limits increased to 45 percent from 35 percent for each. For Sale Residential and Land Development reduced to 10 percent from 20 percent. Senior Housing removed as a stand-alone property type, will be included in Other Property Types going forward. Urban Mixed-Use added as a property type with a limit of 10 percent.
 - iv. LTV Limits Reduced. Total Portfolio limits reduced from 65 percent to 50 percent. Risk classification limits reduced in Value Add and Opportunistic from 65 percent and 75 percent respectively to 50 percent for each. Core risk classification limit increased slightly from 45 percent to 50 percent.
 - v. Debt Service Coverage Ratio. Minimum value of 1.50 established for Strategic Portfolio; Core minimum value increased from 1.50 to 2.00.

- F. Standardized Terms. For Partnership Agreements, updated to reflect new Alignment of Interest Principles.

Transitioning to New Policy

Due to current market conditions, the structure and size of the real estate portfolio, and implementation of the Strategic Plan, Staff estimates it will take five to seven years to transition the portfolio to full compliance with the new policy. As detailed previously, the proposed policy allows Staff to approve transactions during the transition period in cases where key policy parameters (a defined term in the proposed policy) exceed limits or the transaction would cause limits to be exceeded on a prospective basis. Staff recommends, in addition to existing reporting requirements listed below, that the Board Real Estate Consultant document in its required memorandum regarding compliance with policy and delegated authority, when a transaction exceeding limits has been approved pursuant to this policy language. The Board Real Estate Consultant shall provide memorandum copies to the Investment Committee Chair and Chief Investment Officer immediately upon completion.

The purpose of this request is multifaceted. During the transition period Staff will occasionally be required to make investment decisions in cases where long-term strategic goals or objectives conflict with current portfolio limits in any given area due to the composition of the current portfolio. For example, Staff may identify compelling value add or opportunistic opportunities that fit the strategies of the new Domestic and International Tactical sub-Portfolios, however, if the proposed investments are in areas where key policy parameters exceed limits at the overall portfolio level due to the composition of the Legacy Portfolio, Staff would otherwise not be able to consider and pursue the opportunities.

Likewise, in the Legacy Portfolio, there may be an opportunistic asset with solid fundamentals that remains attractive on a prospective basis but nevertheless requires follow-on capital for a variety of potential reasons. Staff may determine after analysis that the proposed follow-on capital, as a stand-alone investment, makes sense on go-forward basis, and therefore be inclined to otherwise consider and pursue the incremental investment. However, if key policy parameters exceed limits at the opportunistic risk classification level, or the proposed incremental investment would cause limits to be exceeded on a prospective basis, Staff would otherwise not be able to consider the investment, thus jeopardizing the current holdings in the real estate program. It is important to note that this would be the case even if the follow-on capital was immaterial in dollar terms but required to meet a technical debt covenant breach with CalPERS potentially losing its entire investment, including all sunk costs or previous capital invested in the asset.

As illustrated above, there are a variety of reasons why Staff may desire or be compelled to consider such transactions. An alternative solution is for Staff to

bring each of these types of decisions to the Committee for consideration; however, the practical effects of doing so would be prohibitive in terms of costs and time. Staff notes that the proposed policy includes extensive reporting requirements that will apprise the Committee on progress toward implementation of the Strategic Plan and compliance with policy. As is currently practiced under existing policy and protocol, Staff will continue to update the Committee quarterly.

Staff is also scheduled to present to the Committee in May 2011 a proposed new interim Real Asset Delegation Resolution that addresses authority for management of the component programs for Real Estate, Infrastructure, and Forestland. This new proposed delegated authority will govern the Real Estate program during the five to seven year transition period to implement the approved Strategic Plan. Proposed delegated authority revisions for Infrastructure and Forestland will be limited to administrative changes necessary to effectuate consolidation of the Real Assets program under a single Delegation Resolution.

Lastly, Staff will revise and update the Staff Internal Procedure Manual to reflect the approved new Strategic Plan and proposed policy and delegated authority governance documents no later than December 2011.

Programs with Specific Policy Requirements and Related Policies

The proposed real estate policy includes attachments for For-Sale Residential and Land Development ("Housing"), California Urban Real Estate ("CURE"), Public Real Estate Equity Securities ("PREES"), and Agricultural Land Real Estate. Staff will evaluate these legacy attachment policies and respective programs to determine the level to which necessary and valid considerations should be incorporated into the overall policy going forward, consistent with the revised role of Real Estate in the overall CalPERS investment portfolio.

The existing real estate policy for the Responsible Contractor Program ("RCP") will remain in effect as a stand-alone real estate policy. Staff is scheduled to present a revised RCP draft to the Policy Subcommittee in 2011.

Implementation Timeline

Additional items require completion upon adoption of the proposed policy. The following timeline outlines the steps Staff is proposing to complete and effectuate the proposed policy:

Implementation Action	Expected Timing
A. Staff submits proposed Real Assets policy draft to PSC for review and comment.	April 2011
B. Staff submits the PSC approved proposed Real Assets policy draft to IC.	May 2011
C. Staff submits new Real Assets Delegation Resolution to IC for review and approval.	May 2011
D. Staff completes revisions to Staff Internal Procedure Manual to reflect approved Strategic Plan, policy, and delegated authority.	December 2011
E. Staff updates IC on progress toward implementation of the Strategic Plan and compliance with policy.	Quarterly

Board Real Estate Consultant Review

PCA has reviewed and concurs with Staff's recommendation. PCA will be available at the Committee meeting to answer any questions Committee members may have regarding the proposed policy.

V. STRATEGIC PLAN:

The proposed Real Assets policy will further the following CalPERS Strategic Plan goals:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

At this time the Investment Office does not anticipate any additional cost needed to implement the proposed Real Assets policy.

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